An introduction to international arbitration 1

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1.1 Introduction

This chapter is aimed at introducing the reader to the fundamentals of international arbitration. It will firstly cement the legal basis of the parties' autonomy to submit disputes to arbitration and subsequently trace the three phases within which international arbitration is conducted, from the drafting of the agreement all the way to the recognition and enforcement

of the award in a jurisdiction other than that in which it was rendered, where pertinent. Having comprehended how arbitration works we then go on to assess other alternative dispute resolution mechanisms and their benefits (as well as disadvantages) as compared to litigation. The chapter will then examine three fundamental distinctions, namely international versus domestic arbitration, commercial versus non-commercial arbitration and institutional versus ad hoc arbitration. It concludes with two fundamental concepts, namely separability and arbitrability, whose impact the reader will encounter throughout the book. Although many other principles are fundamental to arbitration they are best reserved for other chapters.

1.2 The theoretical foundations of arbitration

Four theories are generally employed to explain the legal foundations of arbitration, namely, the jurisdictional, contractual, mixed (hybrid) and the autonomous theories. Their common underpinning is the interplay between private control and state regulation of arbitration. Adherents of the *jurisdictional theory* suggest that the role of national law, particularly that of the seat of the arbitration, is of paramount importance. While the parties are free to choose arbitration over recourse to the courts and appoint their preferred arbitrators, it is the state which permits them to do so and as a result arbitrators are perceived as exercising a public function and possess a quasi-judicial status entitling them to the immunity enjoyed by ordinary judges.[1]

The *contractual theory* is predicated on the principle of party autonomy, which is explained more fully in the following section. According to this, it is the will of the parties as expressed in their contract that dictates the choice of dispute settlement mechanism. In fact, the parties' agreement to arbitrate overrides the jurisdiction or ordinary courts, the application of conflict of law rules, as well as the vast majority of procedural rules.[2] Unlike the jurisdictional theory, proponents of the contractual theory

[1] See J. D. Lew, L. Mistelis and S. Kröll, *Comparative International Commercial Arbitration* (Kluwer, 2003), 74–5; E. Gaillard, *Legal Theory of International Arbitration* (Martinus Nijhoff, 2010), 15–23.

[2] Lew, Mistelis and Kröll, above note 1, at 76; Gaillard, above note 1, at 24–34.

suggest that arbitral tribunals do not exercise a public function and are instead under a mandate or contract with the parties to provide a service. It should be noted, however, that contractual theory in no way disregards the role of the state in safeguarding the arbitral process, both domestically and internationally.

The *mixed (hybrid) theory* takes the view that arbitration is neither wholly private nor wholly public. It suggests the existence of a synergy between the will of the parties and the role of the state, particularly the seat, in assisting the arbitral process. The role of the state is crucial in giving effect to the will of the parties, rather than assuming a controlling role. By way of illustration, arbitral proceedings would come to a standstill if the parties were unable to agree on the person of the chairman or if third parties refused to surrender evidence to the tribunal voluntarily; not to mention the futility of arbitration if there was no multilateral agreement to recognise and enforce arbitral awards internationally. A practical outcome from the application of the hybrid theory is that arbitral tribunals, although established by reason of contract, do exercise a public function that obliges them to adhere to fair trial guarantees. Moreover, the use of substantive and procedural rules in arbitration is no longer solely anchored to one or more legal systems. Parties are content to rely on trade usages, equitable principles and other transnational rules.[3]

The *autonomous theory*, while using the mixed theory as its platform, views arbitration as a process developed and operating solely to meet the needs of business and trade. In this light, the contractual basis of arbitration entails that national law can be bypassed by agreement of the parties and that even the law of the seat is of little, if any importance.[4] If the parties are able to communicate effectively the arbitral process need not have anything to do with domestic law or domestic institutions; it may be delocalised, as will be examined elsewhere. A particular outcome of the independence of international arbitration from domestic legal orders is the evolution of a discrete arbitral legal order, itself an expression of transnational law.[5]

In practice, all of these theories find a degree of application, although some are more prevalent than others. While reading the various chapters of this book the reader will come to realise the influence of each of these

[3] Gaillard, above note 1, at 35–51.
[4] Lew, Mistelis and Kröll, above note 1, at 80–1.
[5] Gaillard, above note 1, at 52–66.

theories in discrete fields of arbitration. The following section will discuss the principle of party autonomy, not as justification for the contractual theory, but as the key over-arching principle underlying the system of international arbitration.

1.2.1 Arbitration and party autonomy

Arbitration is a dispute resolution process that is consensual and private in nature and operation,[6] as opposed to ordinary litigation whereby the civil procedural rules are not generally amenable to party approval whether in whole or in part; in the majority of jurisdictions they are obligatory at all times. More specifically, the selection of judges in a particular case is determined by law and the parties cannot by agreement limit or restrict the competence or authority of the court, nor can they adapt the rules of evidence even among themselves, although it is true that this is sometimes debated in certain jurisdictions. The boundaries of party autonomy in arbitration are far wider than civil litigation and with few exceptions (especially mandatory rules concerning public interest and the parties' due process rights) the parties may choose or omit any procedural or substantive rules. This freedom is not derived from natural law, but is granted to physical and legal persons by formal law (the law of the seat of arbitration, codified in the law of contracts, civil procedure or other). Arbitration is not the only mechanism where such freedom exists. It is also encountered in other private alternative dispute resolution (ADR) mechanisms, such as mediation, conciliation, expert determination and negotiation.

Despite its otherwise private nature, arbitration would be meaningless if arbitral awards were not amenable to state-sanctioned enforcement. The losing party could unashamedly exhibit bad faith and refuse to abide with the terms of the award. As a result, it becomes obvious that unless the state sanctions, guarantees and protects the institution of arbitration, which includes the parties' agreements, arbitral process and arbitral awards, there would be no incentive to choose arbitration over litigation since it would be devoid of all legal certainty.

The fact that arbitration is based on private agreement and largely regulated by permissive rules of private law does not mean that it exists

[6] *Lafuno Mphaphuli & Associates (Pty) Ltd v Andrews and Another* [2009] ZACC 6, as per the RSA Constitutional Court.

wholly outside any sphere of public regulation. If this were so it would be subject to manipulation by the stronger parties and any abuses emanating from this system of dispute resolution (such as the use of arbitral awards to launder illicit proceeds) would never be resolved by reference to principles of justice and fairness. A good illustration of the public dimension of arbitration is offered in the field of consumer disputes. In European Union (EU) member states pre-dispute arbitration clauses are generally inadmissible and any post-dispute agreements must be individually negotiated between consumers and businesses.[7] Equally, although the parties are free to agree on the procedural rules governing arbitration they are not allowed to forego or circumvent due process guarantees ordinarily applicable in civil proceedings.[8] As will be discussed in other sections of this chapter, states may pose further limitations to party autonomy, such as those relating to arbitrability and public policy.

It is not, however, only domestic law that has an impact on party autonomy to arbitrate. In transnational commercial transactions, multiple legal systems will come into operation and unless states are willing to afford arbitration agreements and arbitral awards mutual recognition and enforcement, recourse to arbitration will always entail a serious risk factor. That is the reason why several international instruments have come into place to unify and harmonise international commercial arbitration. Chief among these is the 1958 New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards and the UNCITRAL Model Law on International Commercial Arbitration. The first sets out a restricted list of grounds which justify the non-recognition and enforcement of foreign awards, whereas the latter is a platform (or a standard-setting mechanism) for the unification of national arbitration laws.

Case study: The limits of party autonomy

The Bulgarian Supreme Court of Cassation was asked to determine the validity of an arbitration clause that provided only one of the parties with a unilateral right to decide whether to refer a dispute to a state

[7] See chapter 9.

[8] As a result, the right to fair trial applies to arbitral proceedings despite the fact that arbitral tribunals are not 'established by law' as dictated by Art 6 of the ECHR. See *Abel Xavier v UEFA* [2001] ASA Bull 566 and more generally chapter 7 section 7.6.3.2.

court or to an arbitration tribunal. It found this contractually based unilateral entitlement invalid under Article 26(1)(1) of the Bulgarian Obligations and Contracts Act. The Court's reasoning was that the unilateral right to choose the method for dispute resolution represented a potestative condition, thus rendering it unenforceable for lack of mutuality of obligation.[9]

1.3 Compulsory forms of arbitration

So far it has been demonstrated that it is solely in the discretion of the parties whether to submit a dispute to arbitration rather than the ordinary jurisdiction of regular courts. Once they have opted for arbitration, the law (of the seat, otherwise known as *lex arbitri*) will set some boundaries with the aim of ensuring the parties' equal treatment and the relative fairness of proceedings, but it will not impose arbitration on the parties. Exceptionally, states will *impose* arbitration on particular classes of private actors, typically in a limited number of disputes involving state entities or concerning some element of public interest (statute-based arbitration).[10] The exclusion of party autonomy here is allegedly justified by the speediness inherent in arbitration, the assurances of fairness provided by the state and the assumption that this is what the private actors would have chosen had they been given the option (essentially, that arbitration under the circumstances is pro-investor). By way of illustration, Greece's Public

[9] *Case (commercial) 193/2010*, Bulgarian Supreme Court of Cassation judgment no 71 (2 September 2011); confirmed also by the French Supreme Cassation Court judgment (26 September 2012) in *Mme X v Banque Privée Edmond de Rothschild* [2013] ILPr 12. This outcome should be distinguished from agreements whereby one of the parties will choose which among two appointing authorities would appoint the arbitrator. OLG Dresden, *case 11 Sch 01/01*, judgment (28 February 2001); see similarly *Mortini v Comune di Alidono*, Italian Constitutional Court judgment (9 May 1996), [1996] Foro pad 4, where compelling parties to submit disputes to arbitration under Italy's public procurement laws was held to be a breach of the private party's right of access to state courts.

[10] Exceptionally, compulsory arbitration has in some cases been extended to wholly private disputes. Part A of the Fourth Schedule to the Maltese Arbitration Act stipulates that condominium, traffic-related and agency disputes are subject to mandatory arbitration. Mandatory arbitration has also been introduced for any dispute in connection with building construction (to the exclusion of claims for personal injuries). Maltese Legal Notice 72 (2013).

Private Partnership (PPP) Law provides that all disputes arising from PPPs will be resolved by arbitration.[11]

Since 2001, pharmaceutical patent disputes concerning the commercialisation of generic medicines in Portugal are to be resolved through mandatory arbitration, in situations where one of the parties argues that the commercialisation of a generic medicine infringes its patent rights. In such cases a special procedure is envisaged whereby when the Portuguese national pharmaceutical agency (Infarmed) receives an application for approval of a generic pharmaceutical product, the innovator may, within thirty days, file a request for arbitration (either ad hoc or institutional), if it claims that the generic medicine is in breach of its intellectual property rights. This form of compulsory arbitration also covers interim injunctions, thus entirely excluding these disputes from the jurisdiction of ordinary courts.

Such mandatory forms of arbitration are exceptional and have rightly given rise to criticism. Given the absence of party autonomy as regards the application of substantive and procedural rules it is even questioned whether such processes have any affinity to arbitration whatsoever. In one case, the Maltese Constitutional Court held that the mandatory arbitration proceedings in question (including the appointment of arbitrators by the chairman of the Malta Arbitration Centre) did not breach the Constitution of Malta (Article 39(2)) or the right to fair trial under Article 6 of the European Convention on Human Rights (ECHR).[12] As we have already discussed, however, the Italian Constitutional Court in *Mortini v Comune di Alidono*, reached a different conclusion.[13]

1.4 Mediation and ADR

When a dispute arises between two or more persons they may choose to resolve it through several available means. If the parties are on speaking terms the natural inclination is to engage in negotiations on the basis of

[11] Art 31, Law No 3389/2005; Law No 3943/2011 on Tax Evasion equally provides for the settlement of relevant tax disputes in Greece through arbitration.

[12] *Untours Insurance Agency Ltd and Emanuel Gauci v Victor Micallef and Others*, App No 81/2011/1, Maltese Constitutional Court judgment (25 January 2013). It should be noted, however, that two years earlier the same court reached a different conclusion in *Vassallo & Sons Ltd v Attorney General Water Services Corp and Enemalta Corp*, App No 31/2008/1, judgment (30 September 2011).

[13] See above footnote 9.

face-to-face discussions. Negotiations are only meaningful if the parties truly desire to resolve their dispute and provided that they are prepared to make at least some concessions.[14] If they reach settlement outside an arbitral process the only way of recording their settlement is in the form of an agreement, whether a contract, a notarised deed or other. The parties may well decide to insert an arbitration clause in their agreement, in which case if a dispute were to arise in the future over the terms of the agreement they could have recourse to arbitration.

If the parties are not on speaking terms and at the same time are not bound by an agreement to arbitrate or do not otherwise wish to submit to the jurisdiction of the courts they may opt for mediation.[15] Mediation may be employed in the case of two feuding neighbours as well as in complex business disputes. The mediator listens to the parties' views and arguments and tries to come up with a proposed settlement that is acceptable to all parties. It is crucial therefore that the mediator understands what is important to each party and what are the interests and pursuits they hold as fundamental. The key to successful mediation is not the rendering of a legally accurate determination setting out which party has breached its obligations, because the breaching party will naturally reject the proposed settlement. Rather, the key is to demonstrate what went wrong, never drive any party to the corner and suggest sensible solutions for the rectification of the issue at hand. Mediators may, and usually do, have to go back and forth with amended terms before the parties reach a settlement. In many situations the most sensible solution is right before the parties' eyes but their mutual anger and resentment does not allow them to conceptualise it; divorce is the classic example!

[14] Controlling one's emotions and understanding the opponent's motivations and desires is key to successful negotiation. See R. Fisher, W. L. Ury and B Patton, *Getting to Yes: Negotiating Agreement without Giving In* (Penguin Books, 2011).

[15] Fromm convincingly argues that there is a human tendency to resort to authoritarianism and authoritarian institutions (such as law and the courts) in order to escape from freedom in the context of stressful situations, such as inter-personal conflicts. In such situations even rational people abandon their communicative and conflict engagement functions (or skills) and resort to the aforementioned authoritarian figures, be they mediators, judges or arbitrators. See E. Fromm, *Escape from Freedom* (Henry Holt & Co, 1986). Other scholars, such as Kuttner take Fromm's psychoanalytical analysis of authoritarianism to explain the extensive use of adjudicatory systems and proliferation of authoritarian legal institutions. See R. Kuttner, From Adversity to Relationality: A Relational View of Integrative Negotiation and Mediation (2010) 25 *Ohio St. J Disp. Resol.* 931.

Once the proposed settlement is accepted by all the parties three options are available in order to render it binding, namely: a) recording the settlement into a new contract; b) recording the settlement into an award (so-called consent awards or awards on agreed terms) in cases where the parties have already entered into an agreement to arbitrate the dispute at hand and the tribunal has already been constituted;[16] or c) recognition of the settlement by a court as having the same legal effect as a judgment, provided that this option in fact exists in the jurisdiction where the parties are situated. Article 6 of the EU Mediation Directive,[17] for example, obliges member states to ensure that the content of a written agreement resulting from mediation be made enforceable either on its own or through a court judgment, although in the latter case this does not necessarily constitute a form of judicial exequatur.

The judicial recognition of a mediated settlement differs from an arbitral award in several important respects. Firstly, the recommendations of the mediator are not binding on the parties; they are merely proposals. Secondly, an approved (by the courts) mediated settlement is binding but is enforceable internationally only under the legal regime applicable to civil judgments.[18] This means that the settlement/judgment is not enforceable as a foreign arbitral award under the terms of the 1958 New York Convention.[19] Thirdly, unlike arbitral awards, which may be subject to set aside proceedings, mediated settlements (that do not constitute consent awards) may be challenged under the law of contract, if recorded in the form of a contract, or by means of appeal or cassation if approved by a first instance court judgment. Other challenges may also be available.

1.4.1 Tiered dispute resolution

It is common for parties to complex contracts, especially in construction, to insert tiered dispute resolution clauses (also known as escalation clauses) in

[16] Art 30 UNCITRAL Model Law; see chapter 7 section 7.3.3.

[17] Directive 2008/52/EC of 21 May 2008 on Certain Aspects of Mediation in Civil and Commercial Matters, OJ L 136 [2008].

[18] Council Regulation (EC) No 44/2001 of 22 December 2000 on Jurisdiction and the Recognition and Enforcement of Judgments in Civil and Commercial Matters, OJ L 12 [2012].

[19] The practical significance is that membership to the 1958 New York Convention is by far higher as compared to membership in any other multilateral convention for the mutual enforcement of civil judgments.

their contracts. These provide for a series of steps in the overall dispute resolution process, whereby, subject to a definite time frame, if the dispute has not been resolved by one step (procedure) the following step is applied. By way of illustration, the first step may consist of structured negotiation, failing which the parties may turn to mediation, from there to early neutral evaluation, followed by expert determination and ultimately arbitration or adjudication. English courts have demonstrated an inclination to enforce escalation clauses, particularly where the language of the clause is mandatory, there is explicit reference to institutional rules or other defined procedure and time frames are clearly set out.[20]

The parties may well feel that traditional arbitration is unsuitable for their business needs. An enforceable award may be far lower on their agenda as compared to speedy resolution in the face of looming deadlines, especially where there exists a good deal of trust. In such cases the parties may simply desire the input of technical experts. As a result, particularly in construction disputes, it is usual for the parties to resort to expert determination whereby the dispute is submitted to an independent technical expert (chosen from a list pre-agreed by the parties) who determines purely technical issues (not matters of law) and whose decision is final and binding.[21] In large, long-term, construction projects there is usually a standing expert-determination panel because of the frequency of relevant disputes. Although expert determination is fast, technically accurate and binding, it does not constitute an arbitral award and is only enforceable as a contract.[22] The test used by Australian courts to distinguish arbitration from expert determination is whether the relevant process was in the nature of a judicial inquiry.[23]

1.4.2 Mediation and ADR as a condition precedent to arbitration

Mediation (and other forms of ADR) is usually designated as a first step in the parties' agreement to arbitrate. Where ADR procedures are stipulated as

[20] *Wah (aka Alan Tang) and Another v Grant Thornton Intl Ltd and Others* [2012] EWHC 3198 (Ch).

[21] *Douglas Harper v Interchange Group Ltd* [2007] EWHC 1834 (Comm); *Union Discount v Zoller* [2002] 1 WLR 1517.

[22] Under Italian law and practice, expert determination is a form of *irrituale* arbitral proceeding, which is discussed below.

[23] *Age Old Builders Pty Ltd v Swintons Pty Ltd* [2003] VSC 307.